United States Court of Appeals for the Second Circuit

APPELLEE'S BRIEF

74-1749

To be argued by
STEVEN H. LIPSITZ

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UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

IRVING GORDON,

Plaintiff-Appellant,

- against -

ROBERT L. BURR and ELPAC, INC.,

Defendants-Appellees,

and

ARNOLD LORD and PHILIPS, APPEL & WALDEN, INC.,
(sued herein as PHILLIPS, APPEL & WALDEN),

Defendants-Cross-Appellants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR DEFENDANT-CROSS-APPELLANT
PHILIPS, APPEL & WALDEN, INC.

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QUESTIONS PRESENTED FOR REVIEW

On Plaintiff-Appellant's Appeal

1. Did the District Court commit reversible error in dismissing the action against defendant-cross-appellant Philips, Appel & Walden, Inc. where plaintiff-appellant, having been given an opportunity to prove actual damages, failed to do so?

2. Did the District Court abuse its discretion in declining to grant plaintiff-appellant a second opportunity to prove damages at a new trial?

On the Cross-Appeal of Defendant Philips, Appel & Walden, Inc.

3.(a) Did not the District Court err in holding that defendant-cross-appellant Philips, Appel & Walden, Inc., a brokerage firm, would be liable to plaintiff-appellant if he had proved damages, even though plaintiff-appellant was not its customer, did not purchase the securities through it, and it had no knowledge of the transaction?

3. (b) If this Court reverses the District Court's dismissal of the action against defendant-cross-appellant Philips, Appel & Walden, Inc., should not said defendant be given an opportunity to meet the burden of proving its "good faith" under Section 20(a) of the Securities Exchange Act of 1934?

PRELIMINARY STATEMENT

This action was brought by plaintiff-appellant Irving Gordon (hereinafter referred to as "Gordon") against the defendants pursuant to Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b) (the "Act"), and Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5 (the "Rule"), to rescind his August 1968 purchase from defendant-appellee Robert L. Burr (hereinafter referred to as "Burr") of 4500 shares of common stock of defendant-appellee Elpac, Inc. (hereinafter referred to as "Elpac") or, in the alternative, to recover $45,000 in damages representing the purchase price he paid for the stock. In substance, Gordon claimed that Burr and defendant-cross-appellant Arnold Lord (hereinafter referred to as "Lord") acting for themselves, and for and on behalf of Elpac and defendant-cross-appellant, Philips, Appel & Walden, Inc. (hereinafter referred to as "PAW"), made nine specifically alleged false statements and misrepresentations of material facts in connection with Burr's sale to him of Elpac stock (4a-9a)*.

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*References in parentheses are to pages of the Appendix.

The action was tried before the Southern District (Bauman, D.J.) without a jury on April 11 and 12, 1973. On November 13, 1973 the District Court rendered its opinion awarding Gordon the remedy of rescission against Burr, and dismissed the complaint against Elpac, Lord and PAW (20a-52a). Judgment was entered in accordance with the opinion on December 12, 1973 (53a-54a).

On May 2, 1974, the District Court rendered its memorandum decision denying Gordon's motion to set aside or modify the judgment to award rescission against Burr and PAW and for a partial new trial on the issue of damages against Burr, Lord and PAW in lieu of rescission (64a-72a).

Gordon appeals both from the judgment and the memorandum order denying his motion (355a). Lord cross-appeals from the District Court's finding that he had violated the federal securities laws (356a-357a). PAW cross-appeals from the District Court's finding that Gordon "in effect amended his complaint" at trial and in his post-trial brief to allege that PAW was a "controlling person" under Section 20(a) of the Act, 15 U.S.C. §78t(a), and, as such, was secondarily liable to Gordon for the acts of Lord (358a-359a).

STATEMENT OF FACTS

PAW will not burden the Court with an unnecessary repetition of all the facts. Instead, it will confine itself here solely to the evidence adduced at trial bearing on the District Court's finding of secondary liability on the part of PAW as a "controlling person" of Lord under Section 20(a) of the Act. Those facts are as follows:

Lord was employed by PAW, a securities broker-dealer, as one of its registered representatives during the period 1965 through November 1968 when he voluntarily left the securities business (14a, 21a, 261a, 292a). At the time of the transaction complained of Lord shared office space with George James, another of PAW's registered representatives, at PAW's office located at 469 Seventh Avenue in New York City (26a, 114a, 178a-179a, 326a). Lord's duties as a registered representative were to buy and sell securities for PAW's customers (261a).

Gordon was <u>not</u> a customer of PAW at the time of his purchase from Burr of 4500 shares of Elpac common

stock (38a, 177a)*. Gordon did not know the identities of any individuals who were officers, directors or shareholders of PAW nor did he ever communicate with any such persons (170a). Gordon knew that Elpac's common stock was publicly traded and that if he had so desired he could have asked Lord to open an account for him at PAW to purchase Elpac stock in the open market (177a).

Among the persons attending the June 1968 meeting in New York City of prospective private purchasers of Burr's stock in Elpac were Stuart Steinberg, Jr. and a Mr. Adlman, both of whom were also employed by PAW as registered representatives (22a, 84a-85a, 148a, 172a-173a, 235a, 240a). Gordon knew, however, that Messrs. Steinberg, Jr. and Adlman were acting strictly on their own as prospective purchasers of Burr's Elpac stock and that they were neither representing nor acting for or on behalf of PAW in connection with the proposed transaction (145a, 148a, 173a, 236a-237a).

*Gordon opened an account with PAW in December, 1969, approximately 9 months after he claimed to have discovered that he had been defrauded (176a-178a).

Indeed, Gordon admitted that no one connected with the transaction ever told him that Lord, or anyone else, was in any way acting for, through, or on behalf of PAW (167a, 169a).

Neither PAW nor Lord received any commissions or compensation of any kind from Gordon or anyone else connected with the Burr offering (169a-170a, 285a, 295a, 331a, 341a). The $45,000 purchase price for the stock was wired at Gordon's instructions directly by his New York bank to Burr in California; the money was not paid to, nor transmitted through,PAW (108a-109a). Moreover, Gordon's certificate for the stock was not delivered to Gordon by or through PAW (120a, Exhibit 6-350a-352a). Lord testified that PAW had "nothing to do" with the transaction (318a).

On July 18, 1968 in Lord's office at 469 Seventh Avenue, Gordon executed a "Statement of Transferee" to be submitted by Burr to the California Commissioner of Corporations to obtain a private offering exemption for the transaction (Exhibit 1, 340a-342a). The blank spaces in the document calling for information were filled in by Lord, not Gordon (303a, 305a). Paragraph 5(e) thereof stated as follows:

I have received advice from the following professional adviser or advisers in connection with my proposed investment in ELPAC, INC.: (state "none" if none).

Arnold A. Lord

PA&W 7 Ave. NYC

10018

(38a, 168a-169a, 341a)

Gordon attempted by telephone to contact Lord several times at PAW's offices subsequent to November 1968 (26a, 39a, 112a-115a, 119a). Gordon stated that he visited PAW's Seventh Avenue office looking for Lord on two occasions; once in December 1968 or January 1969 and another time in March 1969 (26a, 39a, 113a, 117a-119a). On cross-examination, Gordon recanted in part when confronted with the fact that Lord had left PAW in November 1968 (160a-161a, 171a-172a). Gordon stated that no one at PAW had ever told him that Lord no longer worked for it (171a-174a).

In March 1971, two and one-half years after Gordon had paid for the stock, he commenced this action (2a). The complaint charged Burr and Lord acting for themselves and on behalf of Elpac and PAW had made nine separate misrepresentations of material fact inducing his purchase of Elpac stock from Burr (5a-6a). After

trial, the District Court found that eight of the nine alleged representations had either not been made or were not false (28a). A judgment of rescission was awarded Gordon against Burr because the District Court found that Gordon had proven one of the nine representations to have been both false and material (29a-31a). The complaint was dismissed against Lord, Elpac and PAW because Gordon failed to prove any damages despite a reminder from the District Court in that regard (45a, 53a-54a, 67a).

POINT I

THE DISTRICT COURT WAS CORRECT IN FINDING THAT GORDON FAILED TO PROVE DAMAGES AND, THEREFORE, FAILED TO PROVE HIS CLAIM AGAINST PAW.

Gordon prayed for the remedies of rescission and damages in his complaint (9a). During the course of the trial (at the conclusion of his direct examination) Gordon's attorney was asked by the Court whether he intended to offer any proof on the issue of damages and he stated that he would make such an offer.*

> COURT:. . . Do you intend to prove something in the way of damages or do you feel you have done that?
> MR. LOEWINTHAN: We will do that, your Honor.
> THE COURT: All right.
> MR. LOEWINTHAN: Also, we are asking - -
> THE COURT: You are asking for a rescission. I understand that too. (128a)

At a later point during the presentation of Gordon's case the Court admitted into evidence, over strenuous objection, a hearsay statement from one of Gordon's witnesses as to what an unidentified stock broker had told him over the telephone was the "bid"

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*At that point, the only evidence in the record on the issue of damages was Gordon's testimony that he had paid $45,000 to Burr for the stock (108a-109a).

and "asked" prices for publicly traded Elpac common stock on April 11, 1973, the first day of trial - 3 5/8-4 1/8 (241a). No other evidence was offered as to the value of Elpac stock, restricted or publicly traded, on any other date. At the close of the trial, after the parties had rested, Gordon specifically elected rescission as his remedy (334a). He confirmed that election at p. 40 of his Post-Trial Brief (27a).

Gordon does not on this appeal contest the District Court's finding that

> . . . no evidence was submitted on the question of damages under any standard by which they might be computed. (42a)

The finding was clearly not erroneous.

Section 28(a) of the Act, 15 U.S.C. §78bb(a), permits recovery only of "<u>actual damages</u> on account of the act complained of." (emphasis added) The failure to show such actual damages is deemed "a fatal defect in the cause of action" based on a violation of the Act. <u>Estate Counseling Service v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.</u>, 303 F. 2d 527, 533 (10th Cir. 1962); <u>Cf.</u>; <u>Levine v. Seilon, Inc.</u>, 439 F. 2d 328, 334 (2d Cir. 1971); <u>Smith v. Murchison</u>, 310 F. Supp. 1079, 1084 (S.D. N.Y. 1970); <u>Zeller v. Bogue Electric Manufacturing Corporation</u>, 346 F. Supp. 651 (S.D.N.Y. 1972). As the

District Court was careful to point out in footnote 13 of its opinion (51a) and in its decision denying Gordon's post-trial motion in part for a new trial on the issue of damages (67a), there is some dispute amongst the Circuits as to the appropriate measure of damages. The long-standing standard is generally referred to as the "out-of-pocket rule"; i.e., the difference between the contract price (the price paid), and the real or actual worth of the securities. Levine v. Seilon, Inc., supra; Chasins v. Smith, Barney & Co., 438 F. 2d 1167 (2d Cir. 1970). In other words, the measure of damages is the difference between the amount parted with and the value of what was received. Smith v. Bolles, 132 U.S. 125 (1889); Estate Counseling Service v. Merrill, Lynch, Fenner & Smith, Inc., supra, at 533, and the cases cited therein; Ross v. Licht, 263 F. Supp. 395, 410 (S.D.N.Y. 1967); 6 Loss, Securities Regulation, p. 3923 (1969); 2 Bromberg, Securities Law: Fraud - SEC Rule 10b-5, §9.1 at 225-229. Where a defrauded purchaser holds onto the securities for a long period of time, the Tenth Circuit would as its measure of damages compute the difference between the price paid and its value as of the date the fraud had been, or should have been, discovered. Richardson v. MacArthur, 451 F. 2d

35, 43 (10th Cir. 1971); Esplin v. Hirschi, 402 F. 2d 94, 104 (10th Cir. 1968), cert. denied, 394 U.S. 928 (1969).

Applying any of the standards for measuring damages to the facts here, Gordon offered absolutely no proof of the real or actual value of Elpac stock, restricted or publicly traded, on the date he purchased it (August 22, 1968) nor did he offer any proof of its value as of the time he claimed to discover the fraud (March 1969). In footnote 2 to his memorandum decision (68a) Judge Bauman noted:

> [Gordon] purchased the Elpac stock in August, 1968 at a price of $10 per share. It appears from the testimony adduced at trial (Tr. 79) that in July, 1968 Elpac was selling at $18 or $19 per share; in any event, it is clear that [Gordon] bought the stock at a price substantially below the market price. This fact does not necessarily preclude some recovery under the 'out of pocket rule', for the actual value of the stock could have been far lower than the market price. It means, though, that under the 'out of pocket rule' [Gordon's] damages were unlikely to approach $45,000. (71a)

Gordon in effect now argues that he is not seeking to recover "actual damages" under Section 28(a) of the Act but, rather, surety-type "rescissional damages" against PAW incidential to his judgment for res-

cission against Burr (67a).* It is submitted that this novel contention is nothing more nor less than a thinly disguised attempt to obtain a second opportunity to prove what he was unable to prove at trial.

With respect to this argument, Judge Bauman stated in his memorandum decision on Gordon's post-trial motion,

> Thus [Gordon] was granted the remedy of rescission exclusively [against Burr] not because he was precluded by the doctrine of election of remedies from seeking damages, but because on the record before me he was not entitled to any damages at all. (67a)

As Gordon's claim is governed by federal law, the state law cases cited by him are irrelevant except to the extent that the federal courts have adopted their rationale. Gordon has cited a number of cases in an attempt to demonstrate the falsity of propositions which have not been advocated by the defendants and are

*It should be noted that this theory was never mentioned by Gordon in his complaint, during the course of trial, in his Post-trial Brief or Proposed Findings of Fact and Conclusions of Law, nor in his proposed counter-judgment. It was an afterthought interposed after judgment was entered.

not raised in the District Court's opinion. Neither PAW nor any of the other defendants have ever asserted that Gordon could not have obtained a judgment awarding him rescission against Burr and damages against the other defendants, whether in a single action or in separate actions. Questions of multiplicity of suits and joinder of parties are not at issue here, and defendants have not asserted that Gordon was required to elect rescission or damages. See Estate Counseling Service v. Merrill, Lynch, Pierce, Fenner & Smith, Inc., supra. Nonetheless, it is clear that had Gordon sued Burr and PAW separately and had he obtained a judgment of rescission against Burr, he would have been entitled to recover from PAW *only* if he proved his actual damages and only to the extent he was unable to collect from Burr. The fact that he joined the two in a single action does not, and cannot, relieve Gordon of sustaining the burden of proving his actual damages against PAW.

In Mack v. Latta, 178 N.Y. 525 (1904), a case heavily relied on by Gordon, the New York Court of Appeals held the plaintiff could, in an action in equity to rescind a subscription for corporate stock, sue as well the two individual defendants, one the

president of the corporation and the other a director and member of the executive committee, who were the chief promoters of the corporation and who made the misrepresentations which induced the plaintiff to subscribe to purchase the corporate stock. The appeal was from a judgment sustaining the demurrer to the complaint of the individual defendants. The Court held that the individuals

> . . . could not escape in an action at law a judgment for such damages as plaintiff sustained, for it is well settled in this state that recovery may be had of a party in such a case although he received no benefit from such transaction. [Id. at 529]

The Court further held that in order to avoid a multiplicity of actions, the Court, sitting as a court of equity, could exercise its concurrent jurisdiction in an action at law based on fraud against officers and agents of the corporation.

A similar result would obtain in an action under the Act. The plaintiff would be allowed to rescind his subscription agreement with the corporation. He could join as defendants the officers and directors of the corporation who by fraud induced him to enter into the contract, and hold such persons liable. In this respect the Mack case, supı is entirely consist-

ent with the federal law governing this action but the decision is not applicable to the facts of the case.

Conveniently overlooked by Gordon is another New York case which is directly on point and which cited and discussed Mack, supra, and related cases. Jacoby v. Duncan, 138 Misc. 777 (N.Y. Co. 1931). There, a contract was rescinded because of misrepresentation inducing its making. The Court held that the party to whom the misrepresentation was made may recover his consideration from the other party to the contract, but not from third parties against whom he was compelled to prove fraud and damages. The court held that joinder of the two causes of action was proper but dismissed the action at law for failure to prove damages.

Gordon's reliance on the decision in Johns Hopkins University v. Hutton, 343 F. Supp. 245 (D. Md. 1972), reversed on other grounds, 488 F. 2d 912 (4th Cir. 1973), cert. denied, 94 S. Ct. 1622 (1974), is also misplaced. Indeed, Gordon admits that the "key issue of the instant case has never been raised in any of the decisions in that case" (Gordon's Brief, pp. 15-16). There, Hopkins purchased certain oil and gas interests from Hutton acting as the seller's agent and as underwriter of the securities being purchased.

Hutton received a substantial commission. The only extensive discussion of rescission was in the first reported decision in the action, 297 F. Supp. 1165, 1208 (D. Md. 1968). The claim involved a violation of Section 12(2) of the Securities Act of 1933, 15 U.S.C. §77l(2), which permits a defrauded purchaser to sue for damages _only_ where he no longer owns the securities. Rescission is the _exclusive_ remedy where the defrauded purchaser continues to own the securities. The court held that Section 12(2) imposes liability for rescission not only upon principals who sell securities, but also upon brokers who act as agents for others. The court found Hutton to be such an agent and, as such, a "person who offers or sells a security" within the meaning of the 1933 Act. On appeal, 422 F. 2d 1124 (4th Cir. 1970), this portion of the decision was affirmed, but the Fourth Circuit reversed the granting of summary judgment in Hopkins' favor on the issue of whether or not Hopkins had pursued its remedy diligently. On remand the court considered the 1934 Act claims, and relying on _Baumel v. Rosen_, 412 F. 2d 571 (4th Cir. 1969), _cert. denied_, 396 U.S. 1037 (1970), the court held that rescission would be available to Hopkins unless it had failed to exercise reasonable diligence in pursuing the

remedy and, in that context, found there to be a question of fact. 326 F. Supp. 250, 261 (D. Md. 1971). The availability of the remedy of rescission against Hutton was never an issue in the case because it was clearly in privity with both the seller and purchaser. That is not the situation here with respect to PAW, which was not acting as anyone's agent and which received no commissions or benefit of any kind from the transaction.

The District Court below correctly found that what Gordon was really seeking was an order of rescission against PAW (67a). It is submitted that on the basis of Gordon's failure to prove damages against PAW, not a party to the contract, the District Court was entirely correct in holding that he was not entitled to such relief (27a-28a, 42a, 67a). Astor v. Texas Gulf Sulphur Co., 306 F. Supp. 1333, 1340 n.6 (S.D.N.Y. 1969). 2 Bromberg, supra at §§2.41(1)(b)(32), 8.5(513). Judge Bauman also noted that, from a practical point of view:

> . . . to permit plaintiff to recover from Lord and PAW so much of the $45,000 that he is unable to retrieve from Burr would be to expose these two defendants to a judgment perhaps greater than that to which [Gordon] might be entitled were he to prove damages. . . . however, . . . on the present record he is not entitled to so much as one cent in damages against any of the defendants. (68a) (emphasis added)

POINT II

THE DISTRICT COURT DID NOT ABUSE ITS DISCRETION IN REFUSING TO GRANT GORDON'S POST-TRIAL MOTION FOR A PARTIAL NEW TRIAL ON THE ISSUE OF DAMAGES AGAINST PAW AND TO MODIFY THE JUDGMENT SO AS TO HOLD PAW LIABLE FOR RESCISSIONAL DAMAGES

As the District Court recognized, motions under Rules 59(a) and 60(b) of the Federal Rules of Civil Procedure ("F.R.C.P.") are directed to the discretion of the trial court. Diapulse Corporation of America v. Birtcher Corporation, 362 F. 2d 736 (2d Cir. 1966); Benton v. Vinson, Elkins, Weems, Searls, 255 F. 2d 299 (3d Cir. 1958). Absent a clear abuse of discretion, the trial court's ruling cannot be reversed. International Bureau v. Bethlehem Steel Co., 192 F. 2d 304 (2d Cir. 1951); 6A and 7 Moore's, Federal Practice, §§59.05[5] and 60.19.

Clearly there was no abuse of discretion here. The District Court found with respect to plaintiff's motion under F.R.C.P. 59(a) as follows:

> [Gordon] had ample opportunity to submit proof of damages at the trial; indeed, at one juncture (Tr. 56), I pointedly inquired whether he intended to offer such proof. [Gordon's] counsel stated that he would but, in fact, he did not....(68a-69a)

This conclusion was in accord with Professor Moore's

apt comment that

> ...a new trial in a court action, will not lie merely to relitigate old matter, nor will a new trial normally be granted to enable the movant to present his case under a different theory than he adopted at the former trial. (6A Moore's, supra, §59.07)

A new trial should not be granted to permit an attempt to submit additional evidence (not newly discovered) on issues previously determined and after a voluminous record has been made and comprehensive briefs filed. Aside from any consideration of the principles of res judicata, as a practical matter, any holding to the contrary would open the door for parties to continue to relitigate old matter in an attempt to bludgeon their adversaries into submission because of the undoubted prejudice, burden and expense that such a continuation would necessarily entail.

With respect to Gordon's motion under F.R.C.P. 60(b), he argues that based on his interpretation of, and reliance upon, Mack v. Latta, supra, it was his understanding of the law that a judgment rescinding the sale was sufficient to bind all of the defendants, not merely Burr, the seller (58a-59a, Gordon's Brief, p. 36). Gordon now claims that his own erroneous view of the law was "mistake, inadvertence, surprise or excusable

neglect" within the meaning of F.R.C.P. 60(b). Gordon's own "manifest error of law or fact" rather than that of the trial court which bent over backwards to apprise him of his burden and even went so far as to admit incompetent and irrelevant evidence on the issue of damages cannot provide the basis for reversal upon appeal.

Furthermore, Gordon's belated claim makes no sense in the context of his clear attempt to prove damages in addition to the elements required for rescission. There was no misunderstanding as to the applicability of the Mack case, supra. Judge Bauman recognized this by citing U.S. v. Erdoss, 440 F. 2d 1221 (2d Cir. 1971) (69a). A party will not be relieved of the consequences of an informed choice simply because it develops that the choice was unfortunate. Dal International Trading Company v. Sword Line, Inc., 286 F. 2d 523 (2d Cir. 1961); Bershad v. McDonough, 469 F. 2d 1333 (7th Cir. 1972).

POINT III

THE DISTRICT COURT WAS CLEARLY ERRONEOUS IN FINDING THAT GORDON'S CLAIM FOR RESCISSION WAS NOT BARRED BY LACHES

The District Court correctly recognized that

the equitable defense of laches is considered by a majority of the courts to be applicable to a plaintiff's claim for rescission under the Act (43a). A plaintiff purchaser's failure to act diligently by demanding rescission and tendering the securities once he discovers the facts alleged to constitute a fraud bars him from any recovery. This is so notwithstanding that applicable statutes of limitations have not expired. Royal Air Properties v. Smith, 312 F. 2d 210 (9th Cir. 1962), later case, 333 F. 2d 568 (9th Cir. 1964); Hecht v. Harris, Upham & Co., 430 F. 2d 1202 (9th Cir. 1970); Straley v. Universal Uranium and Milling Corp., 289 F. 2d 370 (9th Cir. 1961), later case, 312 F. 2d 745 (9th Cir. 1962); Baumel v. Rosen, supra; Tobacco and Allied Stocks v. Transamerica Corp., 143 F. Supp. 323 (D. Del. 1956), aff'd., 244 F. 2d 902 (3rd Cir. 1957); Collins v. Rukin, 342 F. Supp. 1282 (D. Mass. 1972). The rationale behind these decisions is a sound one consistent with the express purpose of the federal securities laws. The policy was well stated in Royal Air Properties v. Smith, supra:

> The purpose of the Securities Exchange Act is to protect the innocent investor, not one who loses his innocence and then waits to see how his investment turns out before he decides to invoke the provisions of the Act. [312 F. 2d at 213-214]

The District Court considered the defense of laches insofar as Burr is concerned (43a-45a) but because it held rescission not applicable to PAW, it did not consider the defense as to it (43a footnote 14, 51a). Assuming, <u>arguendo</u> only, that some form of rescission or "rescissional damages" is now deemed applicable to PAW, the District Court's ultimate finding with respect to the defense of laches should be reversed as clearly erroneous. According to Gordon's own testimony, he admitted that he believed that by March 1969 he had made a "bad investment" and had been "taken". (117a-120a, 123a, 176a) Gordon, being a seasoned investor as well as a public accountant, made absolutely no effort to communicate with the Steinbergs or any of the other prospective investors, some of whose names and business addresses he knew. Neither did he make any inquiry of Burr, Elpac nor any of the principals of PAW. We believe the Court was wrong in finding that little time elapsed between Gordon's discovery of the fraud and his initial efforts to tender the shares or disclaim the sale. (44a) That he may have contacted Mann or Lord in June or July of 1969 and later sought the advice of Mr. Jacobson (whom he believed to be acting as the attorney for the purported group in connection with the

proposed stock purchase) is wholly irrelevant insofar as PAW was concerned. Gordon was obliged to demand rescission from, and tender his shares to, Burr, the seller. This he failed to do. He did not commence this action until April 1971, approximately two years after he claimed to have discovered the fraud. In <u>Baumel v. Rosen</u>, <u>supra</u>, rescission was refused to a defendant who waited a mere 18 months before the discovery of the fraud and the renunciation of the sale.

We also believe the District Court erred in failing to bar Gordon from recovering on rescission \$15,000 of the \$45,000 he paid for the stock. Gordon admitted on cross-examination that only \$30,000 of the total purchase price was contributed by him; the remaining \$15,000 for 1500 shares was contributed by four other individuals whom Gordon testified had agreed that the shares be received in his name. (45a, 136a-139a). While we agree that Gordon may have had standing under F.R.C.P. 17(a) to bring the action in his own name, rescission could not have been awarded him for the full purchase price. <u>Mott v. Tri-Continental Financial Corporation</u>, 330 F. 2d 468 (2d Cir. 1964).

POINT IV

THE DISTRICT COURT ERRED IN HOLDING PAW LIABLE UNDER SECTION 20(a) OF THE ACT

The District Court specifically found that on the basis of the evidence adduced at trial PAW could not be held primarily liable under Section 10(b) of the Act. (38a). The trial transcript is completely barren of any testimony or other evidence that PAW participated in or had any knowledge of Gordon's purchase of Elpac stock from Burr, much less that PAW had any knowledge of Burr's or Lord's activities or representations in connection with that transaction. Moreover, there was no finding that PAW had either conspired with or aided and abetted any of the other defendants in violating Section 10(b) of the Act or the Rule as Gordon had alleged in his complaint. (5a-9a). Judge Bauman found that PAW had not directly or indirectly induced the act or acts constituting the violation with the meaning of Section 20(a) of the Act (38a), but that PAW would be liable under that Section as a "controlling person" because PAW called no witnesses at the trial to prove the defense of good faith expressly provided for therein (39a). This conclusion was predicated on Judge Bauman's

finding that

> [a]t the time of trial and in his post trial brief [Gordon] in effect amended his complaint by alleging that [PAW and Elpac] were "controlling persons" under §20(a)....(36a) (emphasis added)

We submit that these findings are clearly erroneous and constitute manifest error of substantive and procedural law. In holding PAW liable as a "controlling person" of Lord under Section 20(a) of the Act, the District Court extended the concept of brokerage firm liability far beyond any previous decision of the federal courts. On the record presented here, the opinion below imposes an absolute, insurer's liability on a brokerage firm for the acts of an employee committed outside the scope of his employment and not for the benefit of his employer.

In Lanza v. Drexel & Co., 479 F. 2d 1277 (2d Cir. 1973), this Court held *en banc* that a director of a corporation in his capacity as a director (a non-participant in the transaction at issue) owed no duty to insure that all material, adverse information is conveyed to purchasers of the corporation's stock. The majority dismissed the 10b-5 complaint against the director and the brokerage firm which placed him on the corporation's board because the plaintiff failed to prove

that the director had aided and abetted, conspired or was a substantial participant in the fraud. [Id. at 1289] In analyzing liability under Section 20(a) of the Act, the Court found that

> [t]he intent of Congress in adding this section, passed at the same time as the amendment to Section 15 of the 1933 Act, was obviously to impose liability only on those...who fall within the definition of control and who are in some meaningful sense capable participants in the fraud perpetrated by controlled persons...[Id. at 1299] (emphasis added)

In his scholarly opinion in S.E.C. v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973), Judge Tyler analyzed the holding in Lanza v. Drexel & Co., supra, in the context of an injunctive action involving a leak of inside information by a registered representative employed by Lehman Brothers, a broker-dealer. Judge Tyler stated that

> [t]o hold Lehman liable on a theory of respondeat superior would...do violence to the legislative intent underlying the Act [Id. at 1063]

and would

> ...result in the imposition of absolute liability upon broker-dealers in this context. [Id. at 1064]

He therefore concluded that Section 20(a) of the Act, and not respondeat superior, is the appropriate standard

for adjudicating the secondary liability of a brokerage firm for the fraudulent acts of one of its employees. [Id. at 1063] Judge Tyler recognized that a broker-dealer owes the public a duty to supervise its employees in an adequate and reasonable fashion. He cautioned, however, that a non-existent insurer's liability for broker-dealers cannot be read into the statute:

> . . . to recognize more stringent standards for the exercise of control by a broker-dealer over its salesmen does not require the imposition of absolute liability upon the former for every violation of the latter....Every violation of Rule 10b-5 by a salesman does not necessarily imply a breach of the employer's duty to supervise. As Judge Moore asserted in Lanza v. Drexel & Co., "...we are aware that the Rule must be read flexibly, not technically and restrictively. But reading the Rule flexibly does not relieve us of the obligation to define the limits of liability imposed by the Rule and to adhere to common sense. Where a claim is made that is clearly beyond the scope of the Rule, even flexible reading will not legitimatize that claim." 479 F. 2d at 1229. [Id. at 1064]

A proper formulation of the applicable rule of law as enunciated in the Lanza and Lum's cases in the context of this case is that:

(a) a brokerage firm is not an insurer of the honesty of an individual employee in all transactions involving the purchase and sale of securities;

(b) a brokerage firm which is not directly

involved in a securities transaction, does not participate therein or have knowledge thereof, is not under a duty to investigate a transaction in which an employee of the firm may be involved with third persons who are not customers or clients of the brokerage firm. Cf. Lanza v. Drexel & Co., supra at 1281. We submit that, on the undisputed facts of this case, the District Court's finding of liability against PAW is contrary to the standards set forth in Lanza and Lum's. See also Sennott v. Rodman & Renshaw, 474 F. 2d 32 (7th Cir. 1973), cert. denied, 414 U.S. 926 (1973).

The record here shows that Gordon was not a customer of PAW at the time he purchased the Elpac common stock from Burr. (38a, 177a). Burr's offering, a private transaction, was not managed or handled in any respect by PAW and PAW did not act as agent for any of the parties to it; PAW received no commissions or compensation of any kind from anyone, including the buyer and seller (169a-170a, 285a, 295a, 331a, 341a); the purchase price was paid directly by Gordon to Burr, not through PAW (108a-109a); and, the securities were directly transmitted to Gordon by either Burr or Elpac, not PAW (120a, Exhibit 6-350a-352a). Gordon admitted that no one connected with the transaction ever told

him that anyone was acting for, through, or on behalf of PAW. (167a, 169a). Gordon never communicated with any officer of PAW (170a). He did speak with Lord who, at the time of the purchase was employed by PAW as a registered representative, and he did visit with Lord and execute some papers at PAW's offices at 469 Seventh Avenue in New York City. But even Lord, no longer a PAW employee, admitted that PAW had "nothing to do" with the transaction. (318a). There was no document prepared in the ordinary course of PAW's business, such as a customer account card, a customer statement or a confirmation slip issued in connection with this transaction. The only document in evidence bearing in the slightest on PAW's connection with any of the parties to the transaction is the "Statement of Transferee" submitted by Burr to the California Commissioner of Corporations. (Exhibit 1, 340a-342a). The blank spaces in this document calling for information were filled in by Lord, not Gordon. (303a, 305a). In response to paragraph 5(e) thereof calling for the name(s) of those from whom the buyer received investment advice, there is stated

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To justify its adverse holding against PAW below, the District Court made much of this. (38a-39a). Judge Bauman inferred that the reference to "PA&W..." with one of its branch office addresses was

> to insure that [Lord's] institutional affiliation was known to Gordon and to Elpac. (39a)

We submit that this inference was clearly erroneous. Firstly, the "Statement of Transferee" by its very nature was not executed for the benefit of either Gordon or Elpac. It was submitted together with Gordon's investment letter (Exhibits 2 and 3, 343a-345a-1) for Burr's benefit to enable him to obtain a private offering exemption from the State of California to effect the transaction. Surely, the document which was to be submitted to the California Commissioner of Corporations would have set forth more than the letters "PA&W" if there had been any intention to identify PAW as an adviser to Gordon. Gordon could not possibly have thought that the Commissioner would know what the initials stood for. Secondly, in the context of Gordon's knowing that he was not a customer of PAW and what he knew to be PAW's lack of participation in the transaction, he could hardly have thought that the insertion of the letters "PA&W..." was anything more than what he knew to be

Lord's business address. Thirdly, Gordon did not seek the advice of anyone, including PAW, in making his investment (other than his friend and client, Howard Mann)*. In any event, there is no evidence that anyone connected with PAW, other than Lord, had ever seen the document or authorized its issuance.

In addition, the District Court erred in inferring a lack of supervision over Lord's activities from Gordon's attempts to contact Lord by telephone and by visits to PAW's offices. If anything, the fact that no one at PAW, including Lord's own office mate (George James) knew anything about the Burr offering only tends to prove that PAW was not involved. Moreover, that two of PAW's registered representatives were considering the purchase of Elpac stock from Burr cannot have any relevance in light of Gordon's own testimony that he knew those individuals were acting in their personal capacities as prospective investors and were not acting for or on behalf of PAW (145a, 148a, 173a).

The District Court presumed a lack of supervision over Lord by PAW without finding that PAW even

*Howard Mann was a client of Gordon's for many years whose investment experience Gordon respected. It was through Mann that Gordon became acquainted with Lord, Burr and Elpac (21a-22a, 34a).

owed such a duty to Gordon.

On the basis of the record, it is evident that PAW had no knowledge of the transaction between Gordon and Burr. By the very nature of the transaction, Lord could not be expected to make any report concerning it to officers or supervisory personnel of PAW. See Rule 345 of the Rules of the New York Stock Exchange, Inc., 2 C.C.H. New York Stock Exchange Guide ¶2345.17(d)(H). The record does disclose that where PAW had knowledge of Lord's prior activities concerning Elpac it took affirmative steps to see to it that its customers were sufficiently apprised of the risks involved in investing in Elpac's speculative stock. This was on the occasion of Elpac's private placement in May 1968 (prior to the transaction at issue) (21a, 38a, 230a-231a, 269a-270a). On that occasion PAW put together and conducted a "due diligence" meeting for its customers who were interested in buying Elpac stock. That meeting was attended by Lord, by Howard Mann, and by one of PAW's officers and PAW's attorney. The latter conducted the meeting and explained the risks attendant on an investment in Elpac stock. (230a-231a, 269a-270a). The record reveals that PAW went to extraordinary lengths to protect its customers even though it was not itself

connected with the transaction and received no commissions or compensation from it. (271a). See Barthe v. Rizzo, ________ F. Supp. ___________ (S.D.N.Y. 1974), Current C.C.H., Fed. Sec. L. Rep. ¶94,741.

It is significant that the District Court chose to ignore Sennott v. Rodman & Renshaw, supra, a case directly on point. There, the plaintiff had been a customer of the brokerage firm. During a period of several years the plaintiff had purchased and sold securities through the firm. William Rothbart, a partner of the brokerage firm, had processed the transaction on the recommendation of his son, Jordan, who had at one time been employed by the firm. The fraudulent conduct complained of was perpetrated by Jordan Rothbart. The private transaction involved was not processed through the brokerage firm and the brokerage firm received no commission from it. The Seventh Circuit carefully considered the brokerage firm's liability both under common law principles of agency and Section 20(a) of the Act. The Court reversed the trial court's judgment against the brokerage firm. It held that a brokerage firm could only be held liable for the fraudulent sale of securities in the ordinary course of the brokerage firm's activities. No liability could be imposed

by the same employee participating in a fraudulent sale involving a private placement of securities where the customer had not purchased the securities through the brokerage firm. Judge Pell stated:

> [The brokerage firm's] duty to control its partners and agents, as well as its past employees, in situations such as this extends only to transactions with or by these parties where [the brokerage firm] is itself involved. To extend it further would be to impose liability upon [the brokerage firm] for virtually any act of its past or present employees and partners regardless of how remote that act might be to [the brokerage firm]. We are not inclined to read Section 78t so expansively. [474 F. 2d at 40]

We submit that in a case involving brokerage firm liability under Section 20(a), a finding must first be made that the brokerage firm was under a duty to supervise and investigate the transaction before considering whether or not it acted in good faith. The duty to supervise and investigate, in Lanza, supra, denominated the "duty to convey", arises not only from the relationship between the plaintiff and the brokerage firm but also from the nature of the activities involved in the fraudulent transaction. In Lum's, supra, the employee's access to inside information which he passed on to institutional customers of Lehman Brothers arose from his contacts with Lum's and the institutional customers which

were known to, and authorized by, his employer.*

Another case directly on point and remarkably similar factually is Montazuma Realty Corp. v. Philips, Appel & Walden, Civil No. 70-1809 (S.D.N.Y., Sept. 26, 1972), opinion adhered on reargument (December 1, 1972). The plaintiff in that action had sued PAW alleging in its complaint that it had purchased securities in reliance upon fraudulent misrepresentations made by Jesse Kagel, a registered representative employed by PAW. In addition to asserting that PAW had violated various provisions of the Act, including Section 10(b) and Rule 10b-5, plaintiff claimed that PAW failed to supervise Kagel adequately. In granting summary judgment in PAW's favor, Judge Brieant found that the plaintiff was not a customer of PAW. Kagel had given his investment opinion gratuitously to plaintiff's principal, a Mr. Freedman who was a friend of his, not for the purpose of generating any business on his part and the stock was bought through another brokerage house. Judge Brieant stated:

*In Johns Hopkins University v. Hutton, supra, the activities of the brokerage firm's employee were clearly within the scope of his responsibilities as the syndicate manager in charge of oil and gas investments and the securities were purchased through Hutton by its customer.

> Under the circumstances it cannot be claimed that Kagel was acting under the authority or direction of [PAW] in his capacity as a registered representative. He was not dealing with a client of the firm, nor with his customer. The duty imposed upon a stock brokerage firm is to supervise the relationship between its employees (registered representatives) and those members of the public who come to deal with the firm through its employees and in reliance on the honesty, professional standing and capability of the firm. [Plaintiff] was not such a customer....[PAW's] obligation was to supervise Kagel in the discharge of his agency. The uncontradicted affidavits and portions quoted from the depositions, indicate that Kagel was not acting for and in behalf of [PAW], and that in his dealings with Kagel plaintiff's agent Freedman, did not consider that Kagel was so acting....Plaintiff shows no reliance as to [PAW] and shows no agency on the part of Kagel for [PAW] in connection with the particular representations said to have been made. [Opinion, pp. 3-5]

This is precisely the situation here. Gordon was not a customer of PAW and Lord was not acting for or on behalf of PAW, but merely as a gratuitous agent for Gordon and/or Burr; neither was the transaction conducted through PAW.

We submit that neither the legislative history behind the adoption of Section 20(a) of the Act nor any judicial interpretation of brokerage firm liability under that Section or under any other principle of law has been extended as far as the District Court did in this case. Had the action involved Lord's

participation in a sale from Burr to Gordon of anything other than securities, it is clear that the District Court would have had no difficulty in dismissing the claim against PAW. But to impose liability on a brokerage firm because one of its employees became involved in a sale of securities between two individuals, neither of whom had any connection with the firm, is totally unwarranted and clearly erroneous. If the District Court's finding is affirmed, brokerage firms will be subjected to indeterminate liabilities under the federal securities laws for the acts of employees outside the scope of their employment and over which no degree of supervision or control could possibly be effective. With even the most stringent policies with respect to the extent to which its employees could utilize its name and office facilities, there is no way a brokerage firm can prevent its employees from engaging in transactions involving securities with third persons who have no other relationship with the firm nor does a brokerage firm owe such persons who deal with the employee a duty to supervise.

In addition, PAW was not put on notice prior to the completion of the trial that it would have to

meet the burden imposed on it by Section 20(a) of the Act of showing that it acted in good faith. Nowhere in his complaint did Gordon allege that PAW had committed a violation of Section 20(a) nor did he even allege that PAW had failed to properly supervise Lord (4a-9a). The District Court itself recognized that the only theories of liability pleaded against PAW were based on principles of agency and aiding and abetting (36a). A thorough review of the trial transcript fails to reveal any mention whatsoever about Section 20(a) in any context. Indeed, the District Court was unable in its opinion to provide any reference to the transcript where any motion to amend the complaint to state a Section 20(a) claim was requested or granted. The <u>only</u> reference to Section 20(a) ever made by Gordon in respect of PAW's alleged liability was in his post trial brief filed more than two months after the trial was concluded and it is worthy to note that even in that document Gordon made no request of any sort to amend his complaint to state such a claim (Gordon's Post-trial brief, pp. 26, 32-34)*.

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*As a matter of record, Gordon did not even request a Section 20(a) finding against PAW in his proposed findings of fact and conclusions of law although he did request such a finding against Elpac.

We submit that it was reversible error for the District Court to have found PAW liable on a statutory cause of action not pleaded and as to which no motion to amend the complaint had ever been made by Gordon. PAW did not in any way expressly or impliedly consent to try the issue of Section 20(a) liability.* PAW chose not to produce any witnesses at the trial because of its firm belief that Gordon simply failed to establish a prima facie case on the causes of action pleaded against it. Clearly, its belief was justified because the District Court found that PAW could not be held liable under Section 10(b) of the Act.

By permitting a post trial amendment to the

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*Almost the same set of circumstances as here had occurred in the Lum's case, supra. There, the SEC admitted that it had never alleged in its complaint or otherwise any liability based on Section 20(a). However, at the completion of trial the SEC did move to amend its complaint to charge the broker-dealer defendant with failure to supervise its employee. The SEC claimed that such an amendment might provide a basis for finding a Section 20(a) violation. Judge Tyler saw fit to mention in footnote 2 of his opinion that the authorities cited for that proposition were not in point. [365 F. Supp. at 1061]. Nevertheless, the Court ruled on the Section 20(a) issue because the brokerage firm had consented to adjudicate it on the merits; it produced witnesses at trial to establish the statutory good faith defense and briefed the claim.

pleadings on the court's own initiative, PAW was not put on notice that it would be required to meet the burden of proving its good faith. PAW has taken a cross-appeal from the opinion of the District Court on this issue solely to preserve its rights to present evidence of its good faith in the event this Court reverses and remands for a new trial.

CONCLUSION

For the reasons set forth above, PAW respectfully requests that the judgment of the District Court dismissing the action against PAW be affirmed. The District Court was correct in holding that the plaintiff failed to prove damages and that this failure required the dismissal of the action as against PAW.

If, however, the Court reverses the judgment of the District Court, it is respectfully submitted that the action against PAW should nevertheless be dismissed because the finding of a violation of the federal securities laws by defendant Lord is clearly erroneous* and

*PAW is wholly in accord with, and adopts, the arguments presented by Lord in his brief on the issue of materiality, reliance and causation.

the finding of secondary liability as against PAW as a "controlling person" of Lord under Section 20(a) of the Securities Exchange Act of 1934 is likewise erroneous. At the very least, if the judgment below is reversed, PAW respectfully requests a new trial on the issue of whether or not it acted in good faith.

Respectfully submitted,

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